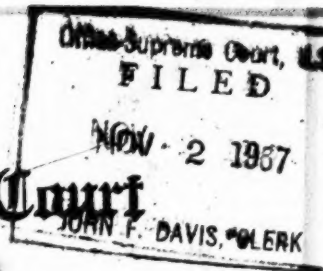


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# **In the Supreme Court**

**OF THE**  
**United States**

**OCTOBER TERM, 1967**

**No. 781**

OSCAR E. BAAN and EVELYN K. BAAN,	}
<i>Petitioners,</i>	
VS.	
COMMISSIONER OF INTERNAL REVENUE,	
<i>Respondent.</i>	

**PETITION FOR A WRIT OF CERTIORARI**  
**to the United States Court of Appeals**  
**for the Ninth Circuit**

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**PETITION FOR A WRIT OF CERTIORARI**  
**to the United States Court of Appeals**  
**for the Ninth Circuit**  
\_\_\_\_\_

Oscar E. Baan and Evelyn K. Baan pray that a writ of certiorari issue to review a reversal of the judgment of the Tax Court of the United States by the United States Court of Appeals for the Ninth Circuit, in a judgment which directly conflicts with that of the Court of Appeals for the Second Circuit.

### OPINIONS BELOW

The Findings of Fact and Opinion of the Tax Court (I-R 79-127)<sup>1</sup>, printed in Appendix B, *infra*, pages 6 to 49, are reported at 45 T.C. 71. The opinion of the Court of Appeals for the Ninth Circuit (I-R), printed in Appendix C, *infra*, pages 50 to 75, has not yet been officially reported, but is unofficially reported at CCH Fed. Tax Serv. (U.S. Tax Cases) par. 9556, and at 20 A.F.T.R. 2d (P-H) 5268. The opinion of the Court of Appeals for the Second Circuit, printed in Appendix E, *infra*, pages 77 to 109, is not yet officially reported, but is unofficially reported at CCH Fed. Tax Serv. (U.S. Tax Cases) par. 9592 and at 20 A.F.T.R. 2d (P-H) 5255.

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### JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was filed and recorded on July 7, 1967 (Appx. D, *infra*, p. 76). Respondent's timely petition for rehearing was denied on August 15, 1967 (I-R). The jurisdiction of this Court is invoked under section 1254(1) of Title 28 of the United States Code, as provided by section 7482(a) of the Internal Revenue Code of 1954 (26 U.S.C. sec. 7482(a), (1964 Ed.)).

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<sup>1</sup>The transcript of the Tax Court hearing comprises Volume Two of the Transcript of Record ("II-R"); the remainder of the record on appeal (except for three volumes of exhibits) is contained in Volume One ("I-R"). Page references are to pages of the Transcript of Record before the Court of Appeals.

**QUESTIONS PRESENTED**

The Pacific Telephone and Telegraph Company ("Pacific"), by action of its board of directors, approved by its shareholders, adopted a plan of reorganization in 1961, pursuant to which the telephone communications businesses conducted by Pacific in the three States of Oregon, Washington and Idaho were divided from the telephone communications business of Pacific which Pacific continued to conduct in the State of California. Pursuant to this plan, Pacific transferred all of its assets pertaining to its operations in the States of Oregon, Washington and Idaho, to a newly organized corporation, Pacific Northwest Bell Telephone Company ("Northwest"), in exchange for the issuance to Pacific by Northwest of all of Northwest's common stock, a \$200,000,000 interest-bearing demand note of Northwest, and the assumption by Northwest of certain operating liabilities of Pacific in these three states. Pursuant to the plan, Pacific issued to all of its shareholders, including petitioners ("taxpayers"), rights represented by short-term transferable stock purchase warrants to purchase all of the common stock of Northwest at a price of \$16 per share. Rights to purchase 57 per cent of the Northwest stock were issued by Pacific to its shareholders in 1961, and rights to purchase the remainder of said Northwest stock were issued by Pacific to its shareholders in 1963. Shareholders owning approximately 95 per cent of the shares of Pacific, at the time said plan was adopted, exercised their rights and became shareholders of Northwest. Taxpayers, owners of 600 shares of common stock of Pacific, received 600 rights to purchase Northwest common stock, which rights were exercised by them on October 11, 1961, when the fair



market value of the Northwest stock was \$26.94 per share.

The question is presented whether under section 355 of the Internal Revenue Code of 1954 (26 U.S.C. sec. 355 (1964 Ed.)) taxpayers received their stock in Northwest as part of a nontaxable spin-off distribution by Pacific of all the stock of a controlled corporation, as held by the Tax Court and the Court of Appeals for the Second Circuit, contrary to the decision of the Court below.

As an independent reason for reversing the Tax Court, the Ninth Circuit Court of Appeals held as a conclusion of fact that the two transfers of the Northwest stock by Pacific in 1961 and in 1963; pursuant to the plan of reorganization, did not constitute "a single transaction" (Appx. C, *infra*, pp. 74,75), contrary to the requirements of section 355(a)(1)(D). An additional question is presented whether the Court erred in making this factual determination directly contrary to a finding of fact by the Tax Court, amply supported by the record, and in response to an issue of law raised by respondent for the first time before the Court of Appeals.

### **STATUTES INVOLVED**

The case directly concerns the interpretation of section 355 of the Internal Revenue Code of 1954 (26 U.S.C. sec. 355 (1964 Ed.)); 68 A Stat. 113-114)<sup>2</sup> which is set out in Appendix A, *infra*, pages 1 to 5.

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<sup>2</sup>References hereinafter to sections are to sections of the Internal Revenue Code of 1954 (26 U.S.C. (1964 Ed.)) unless otherwise expressly stated.

**STATEMENT OF THE CASE**

None of the facts found by the Tax Court were disputed by respondent. As the Tax Court found (Appx. B, *infra*, pp. 6 to 31), petitioners Oscar E. Baan and Evelyn K. Baan, husband and wife and California residents ("taxpayers"), owned through 1961 600 shares of the common stock of The Pacific Telephone and Telegraph Company ("Pacific") (I-R 65), a California corporation engaged since 1907 in furnishing communications services, primarily telephone services, in California. For several decades prior to July 1, 1961, Pacific furnished such services also in Oregon, Washington and a portion of Idaho, but commencing on that date Pacific Northwest Bell Telephone Company ("Northwest"), a Washington corporation, has taken over and furnished such services in those three states (I-R 28). It was stipulated that the businesses Pacific conducted in the three northern states prior to July 1, 1961, were separate from its California business (I-R 40).

American Telephone and Telegraph Company ("American"), a New York corporation, has since 1907 owned about 90 per cent of the voting stock of Pacific (I-R 33), and has since 1961 owned, together with Pacific, about 90 per cent of the capital stock of Northwest (I-R 59). American, Pacific and Northwest are members of the "Bell System" of telephone companies which operates throughout the continental United States and includes 21 telephone company subsidiaries of American (I-R 32-33). Pacific has for many years been included in the consolidated Federal income tax returns filed by American. In 1961, this return also included Northwest (I-R 34).



Pacific's issued and outstanding capital stock in 1961 consisted of 104,756,943 shares of common stock with an aggregate par value of \$1,496,527,844, and 820,000 shares of 6 per cent cumulative preferred stock with an aggregate par value of \$82,000,000 (I-R 29-30). The minority common and preferred shares of Pacific were publicly held by over 38,000 shareholders in 1961. Both the common and preferred shares of Pacific were listed for trading on the New York Stock Exchange and the Pacific Coast Stock Exchange (I-R 33-40).

Between World War II and 1961, Pacific experienced enormous growth in plant investment and operating revenues and in the population served by it. Such growth in the Pacific Coast states was expected to continue. For a number of years prior to 1961, Pacific issued common stock or debentures to obtain an average amount of capital each year of approximately \$200,000,000 to meet its capital requirements. Pacific was, in 1961, the eighth largest non-financial company in the United States in terms of total capital (I-R 40-43).

For purely business reasons, because of the enormous and continued growth and extensive operating territory, Pacific decided to divide the corporation between the businesses and assets operated in the States of Oregon, Washington and Idaho, and the business conducted by Pacific in California. Pacific considered a number of methods to effect such division, one of which was to transfer all of the assets in the States of Oregon, Washington and Idaho to a new corporation which would be distributed in a conventional spinoff to Pacific shareholders, without any consideration by them, or the sur-

render by them of the shares of Pacific. Because of obstacles under the corporate law of California, Pacific was prevented from following this method (II-R 27-30). Instead a plan of reorganization was adopted in 1961 by the directors of Pacific and approved by its shareholders, whereby all of Pacific's business and assets in Oregon, Washington and Idaho were transferred to a new corporation, Northwest, for all of the common stock of Northwest, a \$200,000,000 promissory note of Northwest, and the assumption by Northwest of certain operating liabilities relating to the assets transferred (I-R 44-45). The capitalization of Northwest was structured to be as similar as possible to that of Pacific (I-R 49-50). Under the plan, all of the Northwest stock was to be offered to the Pacific shareholders through short-term rights. It was left to the discretion of Pacific's management, however, to determine the number of offerings of the Northwest stock and the price at which the stock would be made available. The plan contemplated that these decisions would be based on the capital requirements of Pacific, and that all of the stock of Northwest would be distributed within three years. American intended to exercise all of the rights to which it was entitled, thereby ensuring that on such exercise, when the plan was consummated, American would own more than 80 per cent of the stock of Northwest (Exh. 17-Q).

The Northwest stock was offered to Pacific shareholders in 1961 and 1963 (I-R 52, 58). More than 95 per cent of the Northwest stock was received through the exercise of rights by shareholders who were Pacific shareholders at the time the plan of reorganization was adopted (Exh.

54-BBB). Pacific issued no additional Pacific stock or bonds between 1961 and April, 1964, its entire capital requirements during this period having been satisfied from the proceeds of the Northwest stock (I-R 64).

Taxpayers received, as the holders of 600 shares of common stock of Pacific, 600 rights to acquire Northwest stock. These rights would have expired on October 20, 1961, and were exercised by taxpayers on October 11, 1961. On the date of exercise, the value of the Northwest stock was \$26.94 per share, and taxpayers paid \$16 for each share of such stock, in the exercise of their rights (I-R 65).

Respondent determined that taxpayers received taxable dividend income under section 301 in the amount of the difference between the value of the Northwest stock on the date of exercise, and the \$16 a share paid in exercise of their rights, and consequently determined a deficiency in their 1961 Federal income tax (I-R 18-21). On taxpayers' petition filed pursuant to section 6213 of the Code for redetermination of this deficiency, the Tax Court held that section 355 applied to the receipt of the Northwest stock by taxpayers, that the distribution by Pacific of the Northwest stock under its plan of reorganization constituted a tax-free spinoff under said section, and that no taxable income or gain was recognized thereunder (Appx. B, *infra*, pp. 35-38).

The Tax Court found it unnecessary to pass on taxpayers' alternative contentions that no gain should be recognized on the ground that the transaction constituted a tax-free exchange under a plan of reorganization under

section 354, or, in the alternative, a distribution in partial liquidation under section 346 (Appx. B, *infra*, p. 35).

On the Commissioner's petition for review of the Tax Court's decision, the Court of Appeals for the Ninth Circuit reversed the Tax Court and held that section 355 did not apply to the receipt of the Northwest stock by taxpayers. The Court remanded the case to the Tax Court for consideration of taxpayers' alternative arguments (Appx. C, *infra*, pp. 69, 75).

To review this judgment of reversal, taxpayers have filed this petition for a writ of certiorari.

#### **REASONS FOR GRANTING THE WRIT**

1. **THE DECISION BELOW IS IN DIRECT CONFLICT WITH THE RECENT SECOND CIRCUIT COURT OF APPEALS DECISION IN THE COMPANION TEST CASE, COMMISSIONER OF INTERNAL REVENUE v. IRVING GORDON AND MARGARET GORDON.**

A ruling was issued by the Commissioner of Internal Revenue in 1961 that the non-corporate shareholders of Pacific who exercised their rights to purchase Northwest stock would receive taxable dividend income by reason of such exercise (Exh. 67-000). The income tax returns of a great many of these shareholders for the years 1961 and 1963 are still open for adjustment either on claims for refund or the assertion of deficiencies because of the execution of waivers by such shareholders extending the statute of limitations. To challenge the validity of this ruling of the Commissioner, two test cases were instituted in the Tax Court, one the instant case, and the other the

case of *Irving Gordon and Margaret Gordon v. Commissioner of Internal Revenue*. These two cases were consolidated for trial and opinion in the Tax Court, which ruled in favor of the taxpayers and held that no taxable income resulted under section 355 from the exercise of rights to acquire Northwest stock (Appx. B, *infra*, p. 35). Respondent filed petitions for review of this case by the Court of Appeals for the Ninth Circuit (I-R 129-131), and of the *Gordon* case by the Court of Appeals for the Second Circuit. The *Gordon* case was decided by the Second Circuit on July 26, 1967, affirming the Tax Court's ruling that section 355 applied (Appx. E, *infra*, pp. 77-109).

The Second Circuit Court of Appeals disagreed with the Ninth Circuit on certain important aspects of the application of section 355. The Second Circuit ruled directly contrary to the Ninth Circuit that the stock of Northwest had been distributed by Pacific with respect to the Pacific stock, within the meaning of section 355(a)(1)(A) (Appx. E, *infra*, pp. 88-91). The Second Circuit Court of Appeals also disagreed with the Court below in its holding that the requirements of section 355 were not met for the reason that the two offerings of the Northwest stock to the Pacific shareholders, pursuant to the plan of reorganization, did not constitute a single transaction. The Court of Appeals for the Second Circuit held that the two offerings of the Northwest stock constituted a single distribution and that there was no violation of section 355 even if said section could be construed to require a single distribution (Appx. E, *infra*, pp. 93-99).



These two decisions therefore are diametrically opposed in the construction and application of essential elements of section 355. Unless conflict between these two Courts of Appeals is resolved, the tax treatment of the exercise of rights for many thousands of Pacific shareholders who exercised their rights in 1961 and 1963 will be uncertain and will inevitably result in widespread litigation unless the issue in this case is resolved by this Court.

It is understood that the Commissioner is concurrently filing a petition for certiorari with this Court to review the *Gordon* case. The taxpayers in that case will not oppose the Commissioner's request for a writ of certiorari.

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**2. THE DECISION BELOW PRESENTS A CONFLICT BETWEEN THE COURTS OF APPEALS ON IMPORTANT, CONTINUING QUESTIONS OF LAW WHICH SHOULD BE SET AT REST BY THIS COURT.**

The issue in this case involves novel questions in the interpretation and application of section 355. If the Northwest stock had been distributed by Pacific to its shareholders without the payment of cash by the Pacific shareholders, with or without the surrender by them of Pacific stock, the transaction would have qualified as a classic divisive reorganization to which the non-recognition provisions of section 355 are specifically addressed, and no taxable gain would be recognized by the Pacific shareholders on the receipt of the Northwest stock (Appx. B, *infra*, pp. 36-38). The Tax Court found it inconceivable that Congress could have intended, under section 355, that the same receipt of Northwest stock by the



Pacific shareholders would involve a tax, where the recipient Pacific shareholders were required to contribute to the capital of Pacific as a condition to receiving the Northwest stock (Appx. B, *infra*, p. 40). The Second Circuit agreed with the Tax Court that, where the Pacific shareholders could have received the Northwest stock tax-free without the payment of any consideration, the payment by them of \$16 per share for Northwest stock as a contribution to the capital of Pacific should not provide an occasion for the imposition of a tax (Appx. E, *infra*, p. 88). There is no decided case under section 355 or its predecessor provisions under the Internal Revenue Code of 1939 dealing with the situation where cash is paid in by the shareholders to receive stock of the corporation being distributed in a spinoff transaction. The other questions of whether section 355 admits of two distributions and what is necessary to satisfy this requirement if it is present in section 355 are equally novel and important.

Section 355 (Appx. A, *infra*, pp. 1-5) is a comprehensive statute designed to deal in one section with all the divisive corporate reorganizations, whether they take the form of split-offs, split-ups or spinoffs.<sup>3</sup> That section

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<sup>3</sup>The Court below distinguished these reorganizations as follows (Appx. C, *infra*, p. 60, n. 9):

"A split-off involves the same kind of transaction as a spin-off except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. In a split-up, the parent corporation transfers substantially all its assets to two or more corporations and then liquidates, its stockholders surrendering all their stock in the transferor and receiving the stock in the transferee corporations. See Note, *Tax Treatment of Corporate Divisions*, 52 COLUM. L. REV. 408, 409 (1952); Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs*, 6 TAX L. REV., 365 (1951)."

was the embodiment of a Congressional policy that corporate divisions were desirable in the public interest and should not be impeded by tax considerations (Appx. E, *infra*, p. 85).

Unless the questions relating to the interpretation of section 355 are decided in this case and in the *Gordon* case, these important questions of interpretation of section 355 will remain unresolved. The magnitude of corporate reorganizations and their tax effect on shareholders which may arise under section 355 may well be gauged by examining the situation presented here. In this case, the Pacific Company distributed 30,000,000 shares of Northwest stock, and the amount paid into Pacific in the exercise of rights was in excess of a half billion dollars (I-R 54, 59). Pacific had over 38,000 shareholders, and the income tax liability of some 25,000 shareholders will be directly affected by the outcome of these cases (I-R 33; Exh. 54-BBB). A clear understanding of the tax effect of corporate adjustments under section 355 is essential for the administration of the revenue laws and the carrying out of such transactions. Review by this Court in this case is necessary to remove these conflicts and uncertainties now present in this important area of the operation of the income tax laws.

**3. THE DECISION BELOW IS PREDICATED ON A CONCEPT OF THE NATURE OF STOCK RIGHTS FOR TAX PURPOSES WHICH IS DIRECTLY CONTRARY TO THE DECISION OF THIS COURT IN THE LANDMARK CASE OF PALMER v. COMMISSIONER (1937) 302 U.S. 63.**

In the *Palmer* case, the Supreme Court resolved a conflict which had existed among the Courts of Appeals as to the tax effect of the issuance of stock rights by a corporation. The lower courts were divided as to whether a dividend resulted when a corporation issued or distributed stock rights, or when the shareholders exercised their rights. In holding that if a dividend resulted from exercise of rights, the taxable event was the exercise of the rights, the Supreme Court held in the *Palmer* case that the mere issuance of rights to subscribe and their receipt by shareholders is not a dividend, and that no distribution of corporate property results except upon exercise. Rights are mere options which do not effect a distribution of corporate property until they are exercised. This was the view taken both by the Tax Court and Second Circuit Court of Appeals in the *Gordon* case with respect to the Northwest stock rights received and exercised by taxpayers. Both Courts held that there was no distribution of corporate property until the rights were exercised, and that the subject of the distribution by Pacific was not the rights but rather the Northwest stock received on exercise (Appxs. B and E, *infra*, pp. 40-41, 89).

The decision below reflects a fundamental misconception of the nature and tax treatment of stock rights issued by a corporation to its shareholders, as delineated by the decision of this Court in the *Palmer* case. The

Court below held that section 301 was applicable to the "distribution" received by taxpayers from Pacific. The Court's opinion shows clearly that it considered that the subject of the distribution was the Northwest rights rather than the Northwest stock. The Court stated in its opinion (Appx. C, *infra*, p. 63) as follows: "Pacific's distribution of stock rights 'with respect to its stock' logically constitutes the distribution of property within the meaning of section 301." If this decision is allowed to stand, confusion and uncertainties as to the tax treatment of stock rights will result from the improper application by the Court below of the rule of the *Palmer* case.

4. **THE COURT BELOW IMPROPERLY RESTED ITS DECISION ON A FACTUAL DETERMINATION, DIRECTLY CONTRARY TO A FINDING OF FACT BY THE TAX COURT AMPLY SUPPORTED BY THE RECORD, AND IN RESPONSE TO A NEW ISSUE OF LAW RAISED BY RESPONDENT FOR THE FIRST TIME BEFORE THE COURT OF APPEALS. IN SO DOING, THE COURT BELOW HAS SO DEPARTED FROM THE ACCEPTED COURSE OF JUDICIAL PROCEEDINGS AS TO REQUIRE THE EXERCISE BY THIS COURT OF ITS SUPERVISORY JURISDICTION.**

As an independent reason for reversal, the Court held that Pacific did not distribute control of Northwest in a single distribution as required by section 355(a)(1)(D) (Appx. C, *infra*, p. 69). This contention was made by respondent for the first time before the Court of Appeals. In the Tax Court the respondent did not contend that section 355 was not satisfied because of the two offerings of Northwest rights by Pacific to its shareholders in 1961 and 1963. There was no dispute between petitioners and

respondent, and the Tax Court found that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 per cent of the Northwest stock in a single transaction (Appx. B, *infra*, p. 33, n. 4). Nonetheless, respondent contended before the Court of Appeals that section 355(a)(1)(D) as a matter of law required a single distribution as of a single date, and that the offerings of the Northwest stock in 1961 and 1963 were contrary to this requirement of section 355.

The Court below considered this argument on its merits even though advanced for the first time on review, but did so on the ground that it raised a point of law (Appx. C, *infra*, p. 69). Although the Court rejected respondent's legal contention that section 355 required a single distribution, the Court went on to examine the record and make a finding of fact directly contrary to that found by the Tax Court (Appx. C, *infra*, pp. 71, 74-75). The Court of Appeals found that the two distributions of Northwest stock in 1961 and 1963 did not constitute a single transaction, and in so doing the Court below departed from the well-established rule laid down by this Court that factual determinations are to be left to the trial court (*Commissioner v. Duberstein* (1960) 363 U.S. 278).

The record amply supported the Tax Court's determination that the two offerings by Pacific in 1961 and 1963 were component parts of a single plan which resulted in the disposition of all of the Northwest stock in a single transaction (see, e.g., Exh. 17-Q, pp. 8, 11; II-R 46). The factual determination by the Court below to the



contrary in response to an argument of law raised by respondent for the first time on appeal was an improper exercise by that Court of its appellate jurisdiction which should be corrected by this Court.

---

**CONCLUSION**

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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**(Appendices Follow)**